

**DESCRIPTION OF ENTERPRISE
ZONE PROPOSALS
(H.R. 6 AND ADMINISTRATION PROPOSAL)**

SCHEDULED FOR HEARINGS

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON OCTOBER 17-18, 1989

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION



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CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	2
II. PRESENT LAW	5
III. DESCRIPTION OF H.R. 6	10
IV. ADMINISTRATION PROPOSAL.....	17
V. ISSUES RELATING TO TAX INCENTIVES FOR ENTERPRISE ZONES.....	19

(III)

INTRODUCTION

The House Committee on Ways and Means has scheduled public hearings on October 17-18, 1989, on proposals relating to enterprise zone tax incentives: H.R. 6 (The Enterprise Zone Improvements Act of 1989, introduced by Mr. Rangel and others) and the Administration's proposal.

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the enterprise zone proposals. Part I is a summary. Part II is a brief description of related present-law provisions. Part III is a description of the provisions of H.R. 6, and Part IV is a summary description of the Administration proposal. Part V discusses issues related to tax incentives for enterprise zones.

¹ This document may be cited as follows: *Description of Enterprise Zone Proposals (H.R. 6 and Administration Proposal)* (JCS-16-89), October 14, 1989.

I. SUMMARY

Present Law

Tax incentive provisions

Targeted area

The Internal Revenue Code does not contain general rules for targeting areas for special tax treatment. Within certain Code sections, however, there are definitions of targeted areas for limited purposes. For example, the provisions relating to qualified mortgage bonds define targeted areas for the purpose of promoting housing development within economically distressed areas.

Tax credits for employers

There are no general provisions in present law under which an employer's tax liability varies according to the location of its employees. The targeted jobs tax credit in present law does, however, provide a targeted jobs tax credit for a portion of wage payments made to certain groups of employees.

Investment tax credit

An investment tax credit is allowed under present law for qualified rehabilitation of structures: 20 percent for rehabilitation of a certified historic structure and 10 percent for rehabilitation of a building originally placed in service before 1936.

Under prior law, a 10-percent investment tax credit applied to eligible tangible personal property used in a trade or business or for the production of income. The basis of the property was reduced by one-half of the amount of the credit.

Capital gains

Net capital gains are taxed as ordinary income under present law. Before 1987, net gains from the sale or exchange of a capital asset were taxable at a reduced rate. Noncorporate taxpayers could reduce net capital gains by 60 percent, and the remainder was taxed as ordinary income—effectively establishing a maximum 20-percent rate. The maximum tax rate for corporate capital gains was 28 percent.

Private activity bonds

Although interest on State or local government bonds used to finance trade or business activity generally is taxable, various exceptions are provided for what are termed private activity bonds. These include bonds issued as qualified small-issue bonds, as qualified redevelopment bonds, or to finance certain other private activities. Issuance of private activity bonds generally is subject to State volume limitations.

Non-tax provisions

Foreign trade zones

A foreign trade zone may be established within any port of entry. Duties are not levied on imported goods shipped into a foreign trade zone until and unless such goods are sent into other United States territory.

Regulatory flexibility

Present-law provides that certain regulatory procedures be allowed in order to ease the regulatory burden on small businesses, small nonprofit organizations, and small governmental jurisdictions.

Summary of H.R. 6

Designation of enterprise zones

The bill would apply with respect to any area designated as an enterprise zone under the Housing and Community Development Act of 1987, including any area designated before the date of the enactment of H.R. 6.

Tax incentive provisions

Employment tax credits

The bill would provide a tax credit to employers for enterprise zone employment. The amount of the credit would be equal to the sum of two amounts: (1) 10 percent of the qualified increase in an employer's employment expenditures and (2) the applicable economically disadvantaged credit amount for the employee.

In addition, the bill would provide a tax credit to qualified employees of 5 percent of qualified wages.

Investment tax credit

The bill would allow an investment tax credit of 10 percent for new enterprise zone construction property.

Capital gains

The bill would provide that gains on sale of property would not be recognized if the taxpayer used the proceeds within 12 months to acquire enterprise zone property.

Deduction for purchase of stock

The bill would provide a deduction of up to \$100,000 annually per taxpayer for the purchase of newly issued stock in qualifying corporations.

Private activity bonds

The bill would repeal the present-law sunset date applicable to qualified small-issue bonds and would allow accelerated cost recovery methods to be used instead of straight-line depreciation for property financed with private activity bonds for use in designated zones. The bill also would expand the definition of qualified small-

issue bonds to permit tax-exempt financing of facilities engaged in activities other than manufacturing.

Research credit

The bill would provide a research credit for research conducted in an enterprise zone of 37.5 percent.

Tax simplification

The bill contains a Sense of the Congress resolution that would require the Secretary of the Treasury to simplify administration and enforcement of Code provisions amended by the bill.

Effective date

The bill generally would be effective after December 31, 1988.

Summary of Administration Proposal

The Administration's enterprise zone proposal includes three tax incentives applicable to qualifying investments and employees in 50 enterprise zones. The proposal provides a 5-percent refundable tax credit to employees with total wages less than \$20,000 for the first \$10,500 of wages earned in an enterprise zone. Taxpayers may deduct up to \$50,000 annually, with a lifetime maximum of \$250,000, for purchases of qualifying newly issued stock in qualifying corporations. Any capital gain realized on qualifying assets during zone designation periods would be excludible from taxable income. Designation of qualifying enterprise zones would occur in phases: 15 in 1990; 15 more in 1991; 15 more in 1992; and 5 more in 1993.

II. PRESENT LAW

Tax incentive provisions

Targeted area

The Internal Revenue Code does not contain general rules for targeting specific geographic areas for special tax treatment. Within certain Code sections, however, there are definitions of targeted areas for limited purposes. For example, the provisions relating to qualified mortgage bonds define targeted areas for the purpose of promoting housing development within economically distressed areas. Within such areas, which are defined on the basis of the income of area residents or the general economic conditions in these areas, rules for the financing of owner-occupied homes with qualified mortgage bonds are less restrictive than the generally applicable rules.

Tax credits for employers

Under present law, the tax liability of an employer does not vary based on where an employee performs services on behalf of the employer. The targeted jobs tax credit under present law provides a tax credit for a portion of the wages paid to individuals from nine targeted groups. These groups generally are defined according to the individual's physical condition, participation in a specified education or rehabilitation program, or economic status.

The credit generally is equal to 40 percent of the first \$6,000 of qualified first-year wages paid to a member of a targeted group, for a maximum credit of \$2,400. The employer's deduction for wages must be reduced by the amount of the credit claimed. The credit is currently scheduled to expire after December 31, 1989.²

Tax credits for employees

Under present law, the tax liability of an employee does not vary based on where the employee perform services in the United States on behalf of the employer. However, an eligible individual who maintains a home for one or more children is allowed an advance refundable tax credit based on the earned income of the individual. For 1989, the earned income tax credit equals 14 percent of the first \$6,500 of earned income. The credit is phased out if adjusted gross income (or, if greater, earned income) exceeds \$10,240.

Tax credits for investments

An income tax credit is allowed under present law for certain expenditures incurred in rehabilitating certified historic structures and certain nonresidential buildings placed in service before 1936.

² H.R. 3299 (as passed by the House on October 5, 1989) would extend the expiration date by two years to December 31, 1991.

The credit rate is 20 percent for expenditures incurred in rehabilitating certified historic structures and 10 percent for expenditures incurred in rehabilitating buildings originally placed in service before 1936. The basis of any building with respect to which the rehabilitation credit is claimed is reduced by the full amount of the credit.

Before 1986, a 10-percent investment tax credit was allowed for the cost of eligible tangible personal property that was used in a trade or business or for the production of income. The basis of the property was reduced by one-half of the amount of the credit. The investment tax credit was not allowed with respect to real property.

Expensing of certain investments

There is no provision under present law that allows the amount of an investment to be expensed (*i.e.*, deducted for the year in which the investment occurs) based on the location of the investment. Present law, however, provides that in lieu of a depreciation deduction, a taxpayer (other than an estate or trust) may elect to deduct all or a portion of the cost of qualifying property for the taxable year in which the property is placed in service. The maximum amount that may be expensed under this provision for any taxable year is \$10,000. In general, qualifying property is any tangible personal property that is predominantly used in the active conduct of a trade or business.

Nonrecognition provisions

A sale or exchange of an asset generally is a taxable event. However, in a number of instances, gain or loss realized by a taxpayer upon the sale or exchange of an asset is not recognized for Federal income tax purposes. For example, no gain or loss is recognized if property held for productive use in a taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that also is to be held for productive use in a trade or business or for investment (sec. 1031). As another example, a taxpayer generally may defer recognition of gain on the sale of a principal residence if the sales price of the old residence is reinvested in a new principal residence within a specified period of time (sec. 1034). Present law does not provide for nonrecognition of gain or loss in the case of a sale or exchange of an asset that is located within a particular economically distressed area.

Capital gains

Net capital gains are taxed as ordinary income under present law.³ Before 1987, net capital gains were taxed at a reduced rate. All taxpayers other than corporations could reduce net capital gains by 60 percent, and the remainder was taxed as ordinary income—effectively establishing a maximum 20 percent rate. The net capital gains tax rate for corporations was 28 percent. Capital

³ H.R. 3299 (as passed by the House on October 5, 1989) would provide a 30 percent exclusion from income for gains realized after September 14, 1989, and before January 1, 1992, on assets held longer than twelve months. Commencing in 1992, gains would be indexed for inflation and a maximum tax rate on capital gains of 28 percent would be imposed.

assets generally include any property held by the taxpayer with the exception of property used, or held for sale, in the taxpayer's trade or business. This reduction in tax was treated as a preference item for purposes of the minimum tax.

Private activity bonds

Although interest on State or local government bonds used to finance trade or business activity generally is taxable, various exceptions are provided. For example, interest on State or local government bonds is tax-exempt if the bonds are qualified small-issue (used to finance manufacturing facilities or property acquired by first-time farmers) bonds or qualified redevelopment bonds. Tax-exempt private activity bonds issued by States and local governments generally are subject to State volume limitations.⁴ In addition, the depreciation deduction for property financed with tax-exempt bonds generally is determined by using the straight-line method over the class life of the property.

Losses with respect to certain securities

The loss resulting from the worthlessness of a stock, bond, or other evidence of indebtedness issued by a corporation is generally treated as a loss from the sale or exchange of a capital asset. Consequently, the loss is subject to the general rules that limit the amount of capital losses that may be allowed as a deduction for any taxable year.

If an individual incurs a loss with respect to certain small business stock, the loss is treated as an ordinary loss rather than a capital loss. The maximum amount that may be treated as an ordinary loss for any year under this provision is limited to \$50,000 (\$100,000 in the case of a husband and wife who file a joint return).

Research credit

A 20-percent tax credit is allowed for the amount of qualified research expenses paid or incurred by a taxpayer during a taxable year that exceeds the average amount of the taxpayer's yearly qualified research expenses in the base period (generally, the preceding three taxable years). The credit also applies to certain payments to universities for basic research.⁵

Non-tax provisions

Designation of Enterprise Zones under the Housing and Community Development Act of 1987

Pursuant to the Housing and Community Development Act of 1987, the Secretary of Housing and Urban Development (HUD) may designate not more than 100 nominated areas as enterprise zones (42 U.S.C. sec. 11501 *et seq.*).⁶ An area may be so designated

⁴ Under current law, the authority to issue qualified small-issue bonds expires after December 31, 1989. H.R. 3299 (as passed by the House on October 5, 1989) would extend this expiration date to December 31, 1991.

⁵ Under present law, the research credit is scheduled to expire after December 31, 1989. However, H.R. 3299 (as passed by the House on October 5, 1989) would permanently extend the research credit, with modifications.

⁶ HUD has received 270 nominations of areas seeking to be designated as enterprise zones as of the January, 1989 deadline. Thus far, none of the nominated areas has been so designated.

after being nominated by one of more local governments and the State or States in which it is located, and after the Secretary of HUD consults with the Secretaries of Agriculture, Commerce, Labor, and the Treasury, the Director of the Office of Management and Budget, and the Administrator of the Small Business Administration, and, in the case of an area on an Indian reservation, the Secretary of Interior. An enterprise zone designation shall remain in effect for twenty-four years (or until an earlier termination date designated by the State or local government, or until the designation is revoked by the Secretary of HUD).

A nominated area may be designated as an enterprise zone only if it meets the following requirements: (1) the boundary of the area is continuous; (2) the area has a population of not less than 4,000 if any portion of the area (excluding certain qualifying rural areas) is located within a metropolitan statistical area with a population of 50,000 or more; and (3) the area's population is at least 1,000, or the area is entirely within an Indian reservation. In addition, the State and local governments (or Indian reservation governing body) must certify, and the Secretary of HUD must accept such certification, that (1) the area is one of pervasive poverty, unemployment, and general distress; (2) the area is located wholly within the jurisdiction of a local government that is eligible for Federal assistance under section 119 of the Housing and Community Development Act of 1974; (3) the unemployment rate is at least 1.5 times the national unemployment rate; (4) the poverty rate within the area is at least 20 percent; and (5) either (a) at least 70 percent of the households in the area have incomes below 80 percent of the median income of the local government, or (b) the population of the area decreased by 20 percent or more between 1970 and 1980 (42 U.S.C. sec. 11501(c)).

At least one-third of the enterprise zones must be within rural areas, meaning such areas (1) are within a local government jurisdiction(s) with a population of less than 50,000, (2) are outside of a metropolitan statistical area, or (3) are determined by the Secretary of HUD, after consultation with the Secretary of Commerce, to be rural areas (42 U.S.C. sec. 11501(a)(2)(B)).⁷

The Secretary of HUD shall designate nominated areas with the highest average ranking with respect to certain criteria reflecting the areas' unemployment and poverty rates and any decrease in population (42 U.S.C. sec. 11501(a)(3)).

No area shall be designated as an enterprise zone unless the local government and the State (or, in the case of a nominated area on an Indian reservation, the reservation governing body) in which the area is located agree in writing that, during any period during which the area is an enterprise zone, such governments will follow a specified course of action designed to reduce the various burdens borne by employers or employees in such area, including, but not limited to, (1) a reduction of tax rates or fees applying within the area; (2) an increase in the level of public services, or in the efficiency of the delivery of public services, within the area; (3) actions

⁷ A rural area may be designated as an enterprise zone only if it is certified as being an area of pervasive poverty, unemployment, and general distress; but such a rural area need not satisfy all of the specific criteria which a non-rural area must satisfy to be designated an enterprise zone (42 U.S.C. sec. 11501(c)(4)).

to reduce or simplify paperwork requirements within the area; (4) program involvement by public authorities, private entities, organizations, neighborhood associations and community groups, particularly those within the area (including a commitment to provide jobs and job training for, and technical, financial, and other assistance to, employers, employees and residents of the area); (5) the giving of special preference to contractors owned and operated by minorities; and (6) the gift of surplus land in the area to neighborhood organizations agreeing to operate a business on the land (42 U.S.C. sec. 11501(d)).

Foreign trade zones

A foreign trade zone may be established within any port of entry. Duties are not levied on imported goods shipped into a foreign trade zone until the goods are removed to a location in the United States that is not a foreign trade zone.

III. DESCRIPTION OF H.R. 6

Designation of enterprise zones

The provisions of H.R. 6 would apply with respect to any area designated as an enterprise zone under the Housing and Community Development Act of 1987, including any area designated before the date of the enactment of H.R. 6.

Employer tax credit for certain enterprise zone employment

In general

The bill would provide a tax credit to employers for enterprise zone employment. The amount of the credit would be equal to the sum of two amounts: (1) 10 percent of the qualified increase in an employer's employment expenditures; and (2) the applicable economically disadvantaged credit amount for the employee.

The computation would be made on a taxable year basis and would allow for 3-year carrybacks and 15-year carryforwards of unused credits. The credit could not reduce the amount of regular tax (after application of certain credits) in any year below the tentative alternative minimum tax. No deduction would be permitted for wages equal to the amount of credit provided.

If an enterprise zone's designation is revoked under section 701(b)(2) of the Enterprise Zone Act, the zone would be treated as a designated zone for purposes of the credit for the next three years, except that the amount of allowable credit would be reduced.⁸ In the first year following revocation 75 percent of the credit would be allowed; in the second year 50 percent would be allowed; and in the third year 25 percent would be allowed.

Qualified increase in employment expenditures

A credit equal to 10 percent of the qualified increased employment expenditures would be permitted. The amount of qualified wages paid by an employer in designated enterprise zones during a specified 12-month period, which exceeded the qualified wages paid by that same employer during the immediately preceding 12-month period, would be eligible.

To be "qualified wages" for purposes of this credit, wages would have to meet the definition of wages currently in the code for (FUTA) employment tax purposes, with some modifications. One modification would exclude any Federally funded payments the employer received or accrued for on-the-job training. A second difference would relate to special rules for agricultural and railway labor. In no event, however, could qualified wages with respect to any employee exceed 2.5 times the wage base for FUTA taxes. (Cur-

⁸ H.R. 6 refers to the Enterprise Zone Act. This reference appears to be to Title VII of the Housing and Community Development Act of 1987, Public Law 100-242.

rently, the FUTA wage base is \$7,000.) The bill also would provide that wages could not be taken into account for this credit if they otherwise are taken into account in calculating the economically disadvantaged credit, described below.

A phaseout of the credit percentage for qualified increased employment expenditures would be provided. For a taxable year 21 years after the date on which an enterprise zone received designation as such, or for a taxable year 4 years before the date on which a zone ceases to be a zone under section 701(b)(1)(B) of the Enterprise Zone Act, the percentage would be reduced from 10 percent to 7.5 percent. The credit in the following year would be 5 percent, the succeeding year 2.5 percent, and zero percent for all succeeding years thereafter.

Economically disadvantaged credit

The second element of the credit computation would be the economically disadvantaged credit amount which would represent the sum of the applicable percentage of qualified wages paid to each qualified economically disadvantaged individual. Qualified wages are defined as above, except that there is no limitation on the amount of wages that would qualify.

The term "qualified economically disadvantaged individual" would be defined as an individual who possessed each of three qualifications. First, the individual would have to be a "qualified employee". Second, the individual would have to be hired by an employer in a currently designated area and would have to perform services for that employer in that designated area. Third, the individual would have to be certified as either (1) an economically disadvantaged individual, (2) an eligible work incentive employee, or (3) a general assistance recipient. (This certification would be made in a manner similar to that under the targeted jobs credit. (Code sec. 51).) For purposes of this credit, an economically disadvantaged individual would be a member of a family with income (including the cash value of food stamps) during the preceding 6 month period that was no more than the amount which could be paid to a family with no income of the same size as the individual's under the State's aid to family with dependent children program plus the highest cash value of food stamps for which such family could be eligible.

In addition, an employee for whom the employer claimed the targeted jobs tax credit would not be considered a "qualified employee".

The applicable percentage for the credit would be determined by the following table:

Qualified wages paid for services performed during the period after the starting date	Applicable percentage
First 3 years	50
4th year	40
5th year	30
6th year	20
7th through 20th year	10
21st year or later	0

The starting date would be the day the which the qualified economically disadvantaged individuals begins work for the employer within an enterprise zone.

Effective date

The employer credit would be effective for taxable years beginning after December 31, 1988.

Tax credit for enterprise zone employees

In general

A tax credit of 5 percent of qualified wages would be granted to qualified employees. The credit could not reduce the employee's regular tax (after application of certain credits) below the tentative alternative minimum tax.

A qualified employee is defined as above, *i.e.*, at least 90 percent of the services of the employee during the taxable year must be directly related to the conduct of an employer's trade or business located in the enterprise zone, and at least 50 percent of the services must be performed for the employer within the enterprise zone. An employee of the Federal Government or any State or local government would not qualify for these purposes.

Qualified wages are defined as FUTA wages for services to an employer for whom the employee is a qualified employee. Wages for purposes of this credit cannot exceed 1.5 times the FUTA wage base limitation, currently \$7,000.

In a manner similar to the portion of the employer credit for qualified increased employment expenditures, the credit percentage for the employee credit is phased out 21 years after the enterprise zone received such designation or 4 years before termination. In the year following the year specified above, the percentage would be 3.75 percent; the next succeeding year the percentage would be 2.5 percent; the second next succeeding year the percentage would be 1.25 percent; and in all following years the percentage would be zero.

Effective date

The employee credit would be effective for taxable years after December 31, 1989.

Investment tax credit for certain enterprise zone property

In general

Under the bill, a 10-percent investment tax credit would be allowed for investments in certain real property (including lodging) that is located in an enterprise zone if the property is acquired or constructed by the taxpayer and the property is used predominantly by the taxpayer in the active conduct of a trade or business (including the rental of real estate) within the enterprise zone.

In the case of property acquired by the taxpayer, the credit would be allowed only if the property is acquired during the period that the enterprise zone designation is in effect and only if the original use of the property commences with the taxpayer. In the case of property constructed, reconstructed, rehabilitated, renovated, expanded, or erected by the taxpayer, the credit would be allowed only with respect to the portion of the basis of the property that is attributable to construction that occurs during the period that the enterprise zone designation is in effect.

The credit would not be allowed with respect to property that is acquired directly or indirectly from a person who is related to the taxpayer. In addition, the credit rate would be reduced by 25 percent for property placed in service during the year that includes the date that is 21 years after the enterprise zone designation and by an additional 25 percent for each year thereafter.

The basis of any property with respect to which an enterprise zone investment tax credit is allowed would be reduced by the full amount of the credit.

Recapture

If property with respect to which an enterprise zone investment tax credit was claimed is disposed of, a portion of the credit would be recaptured (i.e., the amount of tax for the year of disposition would be increased). The amount of the credit subject to recapture would equal the difference between the full amount of the credit allowed for the property and a recomputed credit based on the amount of time that the property was held by the taxpayer. The recomputed credit would bear the same ratio to the amount of the credit originally allowed as the number of taxable years during which the property was held by the taxpayer bears to the number of years in the recovery period of the property for purposes of computing earnings and profits.

Effective date

The enterprise zone investment tax credit generally would be available for periods beginning after December 31, 1988.

Capital gains

In general

If the taxpayer sold or exchanged any property and within twelve months used the proceeds to purchase qualified enterprise zone property, the bill would permit the taxpayer to elect nonrec-

ognition treatment of the gain on this sale or exchange.⁹ The bill defines qualified enterprise zone property as any tangible personal property used predominantly by the taxpayer in his business within a designated enterprise zone or any real property located within the zone and used by the taxpayer in his business. Qualified enterprise zone property would also include interests in a corporation, partnership, or other entity if for the three years prior to purchase of the interest, the entity was a qualified enterprise zone business.¹⁰

If the taxpayer elected nonrecognition treatment, he or she would be required to adjust the basis of the new property downward by the amount of the gain not recognized. Similarly, the holding period of the new property would be measured from the date of acquisition of the property on which the gain was not recognized.

The election of nonrecognition of gain would not apply to any purchase of stock for which the taxpayer elected to deduct from income the aggregate value of the stock at the time of the purchase of the stock.¹¹

Effective date

The bill would apply to sales or exchanges of qualifying assets after December 31, 1988.

Deduction for the purchase of enterprise stock

In general

The bill would permit a taxpayer, at his election, to deduct from taxable income up to \$100,000 annually for the purchase of qualifying stock in a qualifying enterprise zone corporation.¹² If the election is made, the taxpayer's basis in such stock is reduced by the amount of deduction claimed. Any gain on the subsequent sale of such stock is treated as ordinary income. The taxpayer and all persons related to the taxpayer are counted as one for purposes of applying the \$100,000 limitation. If the taxpayer purchases more than \$100,000 of qualifying stock in any year, the deduction is distributed *pro rata* across the stock purchased.

The original issue of stock, the proceeds of which are to be used in the conduct of a qualified enterprise zone business, constitutes qualifying stock. Qualifying enterprise zone corporations are those corporations which conduct a qualified enterprise zone business and do not at the time of issuance of the stock have a net worth in excess of \$2 million. In addition, to be a qualifying corporation, the corporation must not for the five years beginning with the issuance

⁹ The election of nonrecognition treatment applies to gains only, not to losses.

¹⁰ The bill defines a "qualified business" as one actively engaged in the conduct of a trade or business within an enterprise zone during each of the three preceding taxable years. In addition, such business must have generated at least 80 percent of its gross receipts from activities carried on within the zone, and have substantially all of its tangible assets located within the zone. Ownership of residential, commercial, or industrial real property within a zone would qualify as conduct of an active trade or business within the zone.

¹¹ See the discussion below on deductions for purchase of enterprise stock.

¹² Amounts paid after the close of the taxable year for the purchase of qualifying stock would be eligible for the deduction if the amount was paid not later than the time prescribed for filing the taxpayer's return for the taxable year for which the deduction was being claimed, or if the taxpayer was under a binding contract as of the close of the taxable year to purchase qualifying stock.

of the qualifying stock have any outstanding securities which are registered on a national exchange,¹³ or are registered under section 12(g) (without regard to section 12(g)(2)) of the Securities Exchange Act of 1934.¹⁴ Further, during the five-year period beginning with the issuance of the qualifying stock, not more than 50 percent of the gross receipts of the corporation can arise from royalties, rents,¹⁵ dividends, interest, annuities, and sales and exchanges of stock or other securities.

If, within three years, the taxpayer disposes of any enterprise zone stock on which he elected a deduction, the taxpayer must include in his income an enterprise stock recapture amount. The enterprise stock recapture amount is the amount of interest which would have accrued on the tax saved by the taxpayer at the time of purchase of the securities by reason of the deduction. In addition, should the issuer cease to be qualified at any time during the five years following the issue of the securities, the taxpayer must include in his income the amount claimed as a deduction at the time of purchase of the securities plus the amount of interest which would have accrued on the tax saved by the taxpayer at the time of purchase of the securities by reason of the deduction.¹⁶

Effective date

The bill would apply to purchases of qualifying stock after December 31, 1988.

Private activity bonds

Present law establishes a sunset date of December 31, 1989 for the issuance of qualified small issue manufacturing facility bonds.¹⁷ The bill would revoke the sunset date as it applies to qualified small issue bonds for facilities located within enterprise zones. Moreover, the bill would permit tax-exempt financing of enterprise zone facilities engaged in activities other than the manufacturing or production of tangible personal property.

The bill would permit qualified enterprise zone property that was financed with the proceeds of tax-exempt bonds to use the accelerated cost recovery system which would apply in the absence of tax-exempt financing. Current law requires an alternative system of straight-line cost recovery over a longer recovery period for property financed with tax-exempt bonds.

Effective date—The bill would apply to bonds issued after December 31, 1988.

¹³ As provided under section 12(b) of the Securities Exchange Act of 1934.

¹⁴ For purposes of satisfying the net worth and five-year tests, the issuer and all persons related to the issuer are treated as one person.

¹⁵ Other than rents of those qualifying zone businesses whose business is the rental of real estate, as discussed above.

¹⁶ It appears to be an unintended consequence that, under the bill, a taxpayer who purchased qualifying stock in year one and sold it in year four, would be subject to this recapture provision if the corporation ceased to qualify in year five, even though the taxpayer no longer held the stock.

¹⁷ The Omnibus Budget Reconciliation Act of 1989 (H.R. 3299, as passed by the House on October 5, 1989) would extend the authorization of qualified small issue IDBs to bonds issued before January 1, 1992.

Research credit

Under the bill, a 37.5-percent credit would apply to the amount of qualified research expenditures incurred by a taxpayer during a taxable year for research conducted in enterprise zones that exceeds base period qualified research expenses conducted in enterprise zones.^{18, 19} An area would be treated as an enterprise zone for a base period with respect to a taxable year if such area is designated as an enterprise zone for such taxable year.

Effective date—The enhanced research credit for research conducted in enterprise zones would apply to taxable years beginning after December 31, 1988.

Tax simplification

The bill contains a Sense of the Congress resolution that would urge the Secretary of the Treasury to simplify administration and enforcement of Code provisions amended by the bill.

¹⁸ The amount of enterprise zone qualified research expenses for which the 37.5 percent credit would apply could not exceed the amount by which the taxpayer's *total* qualified research expenses (for research conducted within and without enterprise zones) for a taxable year exceeded the taxpayer's *total* yearly qualified research expenses (for research conducted within and without enterprise zones) in the base period.

IV. ADMINISTRATION PROPOSAL ²⁰

Designation of enterprise zones

Under the Administration's enterprise zone proposal, 50 zones would be designated over a four-year period—15 in 1990, 15 more in 1991, 15 more in 1992, and 5 more in 1993. The President's proposal provides that the characteristics of the enterprise zones would be consistent with the distress requirements applicable to the designation of enterprise zones under the Housing and Community Development Act of 1987.

Refundable wage credit for low-income zone employees

The Administration proposal would provide a 5-percent refundable tax credit for the first \$10,500 of wages paid to an individual working in an enterprise zone and having total wages below \$20,000.²¹ The maximum credit is \$525, and the credit is phased out between \$20,000 and \$25,000 of total wages.

Expensing of investor purchases of small zone corporate stock

Under the Administration proposal, investors could deduct currently ("expense") investment in newly issued corporate stock of qualified small subchapter C corporations. Expensing would be available for investments in corporations having less than \$5 million of total assets, so long as the investments coincide with comparable increases in the corporation's tangible zone assets. Substantially all the activity of qualified corporations must be located in designated enterprise zones.

The deduction for the purchase of qualifying newly issued stock would be available up to \$50,000 annually per individual taxpayer, with a \$250,000 lifetime limit. These deductions reduce the investor's basis in the stock. Consequently, any gain attributable to expensed stock would be taxable at ordinary rates. Amounts expensed would be subject to existing Code limitations, including the alternative minimum tax. The proposal intends that the deduction not be combined with other tax subsidies such that a tax subsidy of more than 100 percent results.

Zero capital gains tax rate on tangible zone assets

The Administration proposal would exclude from taxable income any capital gain realized during zone designation periods on qualified assets. Qualified assets must be tangible assets, located in zones, and used in qualified businesses that have operated in zones for at least two years prior to gain realization.

²⁰ As described in a letter from President Bush to Chairman Rostenkowski, dated July 25, 1989.

²¹ While it is not clear in the letter to Chairman Rostenkowski, the intent appears to be that the credit be refundable to the employee.

Gains qualifying for exemption must accrue after zone designation and before termination of the designation. Assets already located in a zone must be appraised at the time of zone designation, as must existing assets relocated into zones following designation. All qualified assets must be appraised at the termination of zone designation.

Effective date

The proposal would be effective after December 31, 1989.²²

²² Except for the provision to phase in the designation of qualifying zones, it is not clear in the letter to Chairman Rostenkowski what effective dates are intended to apply to the other provisions. The intent appears to be that the various provisions be effective after December 31, 1989.

V. ISSUES RELATING TO TAX INCENTIVES FOR ENTERPRISE ZONES

Overview of issues

The effect of tax incentives on the location of investments

At the heart of the enterprise zone proposals (both H.R. 6 and the Administration proposal) is the belief that economic incentives presented through the Internal Revenue Code can redirect investment toward economically disadvantaged areas. Research on the impact of State and local tax factors on the location decisions of firms is inconclusive. On the one hand, lower local property taxes or lower State or local income taxes act directly to lower the cost of doing business in a particular area. This could make low tax jurisdictions relatively attractive to businesses. On the other hand, relatively high tax jurisdictions may provide higher quality public services and are often associated with highly educated and/or highly skilled local labor forces. These factors could offset the higher tax cost of doing business in a high tax jurisdiction. Separating out these conflicting forces is a difficult task and conclusive econometric evidence has not yet been provided on this issue.²³

As an alternative methodological approach to this issue, a number of surveys have been undertaken to address the effectiveness of tax incentives on location decisions as well. Generally, these surveys explicitly ask managers of firms about the importance of financial factors on location decisions. For the most part, these surveys have found that governmentally provided financial incentives (e.g., low interest loans, property tax abatements, income tax credits) are of secondary importance to a firm's location decision. Primary factors for location decisions included items like proximity to markets, availability of suitable raw materials and an appropriately trained labor force, and access to transportation networks. Researchers hypothesize that primary factors attract a firm to a particular geographic region and that secondary factors may affect the particular choice of location within that region.²⁴ However, many economists suggest caution in interpreting the findings of survey research since responses to survey questions may not accurately forecast the economic behavior of decision makers.

²³ For examples on both sides of the issue, see "Why New Firms Locate Where They Do: An Econometric Model", by Dennis Carlton, in *Interregional Movements and Regional Growth* (William Wheaton, ed.), Urban Institute, 1979; and "Econometric Analysis of Business Tax Impacts on Industrial Location: What Do We Know and How Do We Know It?", by Robert Newman and Dennis Sullivan, *Journal of Urban Economics*, March 1988.

²⁴ Examples of survey research in this area include "The Location of Firms: The Role of Taxes and Fiscal Incentives", by Michael Wasylenko, in *Urban Government Finance: Emerging Trends* (Roy Bahl, ed.) Sage Publications, 1981; and "The Failure of Tax Concessions as Economic Development Incentives", by Larry Ledebur and William Hamilton, in *Reforming State Tax Systems* (Steven Gold, ed.), National Conference of State Legislatures, 1986.

Efficiency of tax incentives for enterprise zones

If tax incentives can significantly affect the location decisions of firms, it is unclear whether the induced investment in enterprise zones constitutes net new investment to the nation that would otherwise not have been made or whether it is merely investment shifted from another locale. If investment in enterprise zones replaces investment that would have taken place elsewhere (for instance, if investment moves away from established centers of economic activity and toward designated enterprise zones), the primary effect of the investment incentives would be redistributive. To the extent that investment in enterprise zones is investment which is redistributed from local labor markets with low unemployment to local labor markets with high unemployment, the enterprise zone programs may direct investment from expensive local labor markets to those with an excess of relatively less expensive, under-utilized labor. In this event, the enterprise zone programs may generate efficiency gains for the economy as under-utilized resources are tapped.

In addition to providing incentives to locate existing businesses in particular geographical areas, the incentives could induce the creation of new businesses which would not otherwise have been initiated in any location. Such new businesses could produce taxable profits and incomes which might reduce the revenue cost of the incentives. On the other hand, the incentives could induce investments into enterprise zones which would be uneconomic in the absence of the tax incentives. Such an outcome would reduce the efficiency of aggregate national investment.

If enterprise zones provide sufficient incentives to affect the location decisions of firms, an additional question is whether these incentives are provided in a cost-effective manner. To be cost-effective, the tax subsidies provided should be the smallest subsidies needed to achieve the desired behavioral change. Moreover, the subsidies should be narrowly targeted so that the benefits of these subsidies go primarily to firms that change their economic behavior in the desired fashion. That is, a cost-effective tax incentive program would minimize the amount of subsidy going to investors who would have located in the enterprise zone even in the absence of the tax subsidy program. Clear definitions of what areas constitute an enterprise zone for purposes of these tax incentive programs may aid in fashioning cost-effective tax subsidies.

Neutrality

Preferential treatment for employment and investment in enterprise zones creates non-neutrality in employment and investment decisions. Non-neutralities can create an inefficient allocation of resources as it can be more profitable, on an after-tax basis, to locate property at site A rather than site B, even though on a pre-tax basis site B would produce greater pre-tax profits. On the other hand, such non-neutralities may be necessary to promote the social goal of more economic growth and opportunity in distressed areas.

Deferral v. exemption

Proposals to provide tax incentives for enterprise zones generally provide certain forms of income deferral from tax or exemption from tax. Exempting income from taxation is always more valuable to the taxpayer than deferring taxation on the same income. For example, if \$1,000 could be invested for 10 years to earn eight percent annually and those earnings were exempt from taxation, this investment would have accumulated \$1,158.93 in interest by the end of the 10-year period. If the earnings instead were taxed annually to a taxpayer at a 28-percent marginal tax rate, the accumulated interest, net of taxes, would be \$750.71 after 10 years. If the earnings were not taxed annually, but rather the tax was deferred for 10 years and assessed on the accumulated interest at the end of the 10-year period, the value of the taxpayer's net earnings would be \$834.43. In this example, deferral increases the taxpayer's return by 11.2 percent over the 10-year period compared to annual taxation. Exemption is 38.9 percent more beneficial than deferral over the same period.

The benefit of tax exemption generally is greater to a higher-income taxpayer than a lower-income taxpayer, because the tax liability saved per dollar of tax-exempt income is greater for taxpayers in higher tax brackets. The benefit of deferral depends not only on the taxpayer's current tax rate, but also on his or her future tax rate. The benefit of deferral is increased for a taxpayer who currently is taxed at a high marginal rate, but who can defer the tax liability until a lower marginal rate applies. The benefit of deferral is decreased if the taxpayer currently is taxed at a low marginal rate and defers the tax liability to a year when a higher marginal tax rate applies. In this circumstance, because of the taxpayer's low initial tax rate, the taxes deferred may actually be worth less than the taxes owed at the later date when the taxpayer is in a higher tax bracket.

Equity considerations

Equity issues are also raised by the proposed enterprise zone legislation. Horizontal equity would require that taxpayers in similar situations be treated by the tax system in the same manner. Vertical equity would require that taxes be assessed in line with the taxpayer's ability to pay. To the extent taxpayers with identical economic incomes bear different income tax burdens as a result of the enterprise zone tax incentive programs, the goal of horizontal equity is not attained. To the extent that the benefits of enterprise zone tax incentives accrue primarily to high income taxpayers, the vertical equity of the income tax system may be compromised.

Tax incentives may be structured as either deductions or credits. When taxpayers face different marginal tax rates, deductions yield different dollar amounts of tax benefits depending upon the taxpayer's tax bracket. As the taxpayer's income and marginal tax rate increase the tax subsidy increases. Credits yield the same dollar of tax benefit to all recipients.²⁵

²⁵ This is not strictly true if the taxpayer has an insufficient tax liability to utilize the credit and the credit is not refundable.

Employer tax credit for enterprise zone employment

The employer credits in H.R. 6 consist of two separate credits: a credit for increased employment and a credit for wages paid to the economically disadvantaged.

Credit for increased employment expenditures

The 10-percent credit for increased employment expenditures is intended as an incentive for the expansion of employment and wages beyond a base period level of wage expenditures. Because only wages below the designated cap (currently \$17,500) would be eligible for the credit, the credit would provide an incentive for part-time or modestly compensated labor. For example, an increase in wages paid from \$17,000 to \$18,000 for additional work performed by a current employee would not be eligible for the credit, but hiring a part-time employee to do the same work for \$1,000 would generate wages eligible for the credit.

The employer credit for increased employment expenditures is a marginal credit relative only to the amount of qualified wages paid by the employer prior to designation as an enterprise zone. In the case of a business that starts up after an area is designated as an enterprise zone, *all* qualified wages would be eligible for the credit every year. Also, if in later years the amount of employment and qualified wages decline from a previous higher level, the amount of wages paid in excess of the amount paid before the area was designated an enterprise zone would still qualify for the credit.

Credit for economically disadvantaged

An additional amount of credit would be provided for wages paid to certain economically disadvantaged employees. The credit would be 50 percent of wages paid to these individuals for the first three years of employment, declining to zero percent after 20 years of employment.

A 50-percent wage credit for all wages paid to certain individuals is likely to provide a strong incentive for employment of designated individuals. Some have expressed concern, however, that the amount of credit and length of time over which the credit may be obtained poorly targets the credit. It would be unnecessary, they argue, to provide a substantial credit to an employee who has several years of tenure with a business, regardless of the individual's previous background, in order for the employer to strive to retain that employee. Because it appears the determination of employee eligibility is made only once, the employee may no longer be economically disadvantaged and yet still be eligible for the economically disadvantaged credit for an extended period of time. In addition, there is no requirement that the employee reside within or near the enterprise zone.

Others respond that because the background of economically disadvantaged employees is sufficiently adverse, an employment incentive is necessary over a long period of time to ensure their continued employment. Also, they argue that employment and business activity within a zone will benefit the distressed area regardless of where the employees reside.

Credit for employees

Both the Administration proposal and H.R. 6 would provide a 5-percent credit to employees for some amount of enterprise zone wages. H.R. 6 would provide a credit for the first \$10,500 of wages (based on the FUTA wage base) to employees whose service is directly related to the conduct of a business in an enterprise zone; the Administration proposal has the same base but would reduce the credit amount to zero by \$25,000 of wages and would be limited to employees working in an enterprise zone.

Some argue that the credit would have the greatest effect on the distressed area if the employee were required to work in the enterprise zone instead of only providing services "directly related" to a zone business, as provided in H.R. 6. Proponents claim, however, that it is necessary to provide incentives for businesses to establish operations within a zone, and this credit, on top of the employer credits, will encourage more employment within a zone regardless of where a particular employee is located.

Some question the need to provide a credit to individuals who would otherwise be well compensated and argue that it is prudent to reduce the credit amount for individuals with compensation above a certain level, as is done in the Administration's proposal. Others maintain that new enterprise zone businesses require a mix of skill levels, and an incentive for individuals at all compensation levels to work in these areas is needed.

Investment tax credit

H.R. 6 would provide a 10-percent credit for depreciable real property invested in enterprise zones. The credit, unlike the investment tax credit in the past, would be for depreciable real estate and not equipment. In the past, it has been argued that it was necessary to encourage investment in equipment, rather than real estate, as a means to encourage more productive business activities.

Supporters of the proposal point out that it would be necessary to build up the capital stock in enterprise zones, including the stock of housing. Depreciable real estate, because it is not movable, would have long-term benefits for the enterprise zone area that could not be provided by increased investment in movable equipment.

Treatment of capital gains and purchases of enterprise zone stock

Overview

H.R. 6 and the Administration's proposal on enterprise zones would create preferential treatment for capital gains with respect to enterprise zone property. H.R. 6 would permit taxpayers to defer recognition of gain on any property sold if the proceeds were reinvested in enterprise zone property. The Administration's proposal would exclude from taxable income any gain on qualifying enterprise zone property.

Both H.R. 6 and the Administration's proposal would create a deduction for the purchase of qualifying stock in a qualifying enterprise zone corporation. If the deduction is claimed, the taxpayer's basis in the stock must be reduced by the amount of deduction

claimed, and any subsequent gain is taxed as ordinary income. Consequently, the deduction for the purchase of stock would permit the taxpayer to defer any tax liability both on that portion of current income used to purchase the stock and on any price appreciation of that stock.

Incentives for equity investments

An argument for preferential capital gains tax rates for enterprise zone property and deductions for purchases of enterprise zone stock is that they encourage investors to buy corporate stock in enterprise zone businesses, and especially to provide venture capital for new companies, stimulating investment in productive business activities within the zone.

Opponents of preferential capital gains treatment for zone assets argue that such preferences may create substantial windfalls for owners of existing enterprise zone property. Demand for such property is increased by a tax preference which is available only to property within a specified geographic location, thereby driving up its price. Opponents argue that such windfalls would do little to create new employment opportunities. To the extent that housing, and more generally, land are qualifying assets, the increased demand for these assets could drive up the cost of housing in designated enterprise zones.

Opponents also assert that a preferential tax rate for capital gains, even if targeted geographically, encourages taxpayers to enter into transactions designed to convert ordinary income into capital gains. Proponents counter that such "conversion" opportunities are simply an additional tax incentive for investments in enterprise zones which the preference is intended to encourage.

Opponents of preferential treatment for capital gains on zone property argue that a preferential tax rate on capital gains may be inefficient because the preference is available to investments which would have occurred without the preference as well as to net, new investments. Opponents also question the efficacy of a deduction for the purchase of stock in enterprise zone corporations. They note corporations routinely raise capital and that as a consequence the benefit of the deduction for purchases of corporate stock often may go to investors who would have purchased the stock without the deduction. Proponents of the deduction for the purchase of zone stock respond that even when this occurs the deduction will have encouraged equity investments rather than debt.

Cost of capital

Proponents of preferential treatment for capital gains for enterprise zone property and deductions for the purchase of stock in enterprise zone corporations argue that the cost of capital is high for enterprise zone investments. They argue that a preferential tax rate on capital gains increases investors' net returns in such assets and thereby will lower the cost of capital for such investments. In addition, proponents note, a deduction for the purchase of stock in an enterprise zone corporation makes such stock relatively more attractive than other assets and thereby lowers the cost of raising investment funds. With a relatively lower cost of capital, more investment capital would flow into designated areas.

Opponents argue that because the preference for capital gains accrues only to property located in the enterprise zone, gains in reduced capital costs may be offset by increases in land costs, as the demand for such land increases. In addition, opponents argue that because of the ability to defer gains, the ability to receive step-up of basis at death, and the substantial participation of tax-exempt institutions in the investment markets, the effective tax rate on gains, which helps determine the cost of capital, may be substantially below the statutory rate. For example, one recent study calculated that prior to 1987 the effective marginal tax rate on capital gains, including State taxes, was less than 6 percent.²⁶ On the other hand, proponents of a capital gains tax reduction for enterprise zone property contend that any reduction in a tax on capital may reduce the cost of capital for these investments.

Incentives for risk-taking

Proponents of preferential treatment argue that a reduced tax rate on gains encourages risk-taking, and that investors generally would view investments in designated zones as particularly risky. As a consequence, a preferential capital gains tax rate for enterprise zone property is justified to overcome this outcome of the marketplace. In addition, it is argued, preferential treatment is important for the entrepreneur who often contributes more in time and effort than in capital. Opponents argue that if risk-taking is to be encouraged, a more efficient method might be to reduce the current asymmetric treatment of gains and losses, by expanding the provisions for loss offset in a targeted manner. The financial gains from risk-taking and the creative process are the major rewards entrepreneurs seek.

Length of preference period

Creating a permanent preference for capital gains which occur on property in enterprise zones could bestow benefits on owners of assets long after the economic development of an enterprise zone has progressed to the point that such benefits are unnecessary. Permitting preferential treatment on gains accrued prior to enterprise zone designation may reduce taxes without receiving commensurate employment or productivity growth in return.

On the other hand, proposals which would grant preferential capital gains treatment only during a limited period, such as during the period of enterprise zone designation, would create incentives to sell the enterprise zone property before the end of such period. This could reduce the attractiveness of enterprise zone investments, thereby reducing the effectiveness of the preference. The incentive to realize gain prior to the expiration of the period of preferential treatment could reduce prices for enterprise zone assets and create instability in the market for such assets. Some argue that a preference for a limited period does not promote investment with a long-term view, but rather creates a short-term, unstable investment environment. In addition, limiting the preference to gains which accrue during a specified period necessitates

²⁶ Don Fullerton, "The Indexation of Interest, Depreciation, and Capital Gains and Tax Reform in the United States," *Journal of Public Economics*, February 1987.

appraisals of enterprise zone assets at the beginning and end of the period. Such appraisals can be costly and create tax compliance difficulties.

Private activity bonds

H.R. 6 would provide that property financed with tax-exempt enterprise zone bonds be permitted accelerated cost recovery. This, in effect, creates an additional capital subsidy for investments in depreciable property that is used in designated enterprise zone areas. Some question whether this added subsidy would act generally to provide the necessary incentive to overcome the drawbacks of locating in an economically disadvantaged area or whether it simply would serve as a bonus payment for firms that would have undertaken these investments even in the absence of such a capital subsidy.

The bill also provides for a permanent extension of the small-issue qualified bond sunset date of December 31, 1989 for bonds issued to finance investment in enterprise zones. If investors could be certain that future investments in enterprise zone property could be financed in a tax-exempt manner, they might be more likely to engage in a long-term planning process than if they believed such financing would be available only for a limited period. Presumably, having a long time horizon would contribute to the probability of success of firms locating in enterprise zones. However, the provision of the implicit subsidy of tax-exempt finance for enterprise zone investments could result in financial savings to firms that would have undertaken the investments even in the absence of such a capital subsidy. If this possibility was a major concern, then a temporary extension that would be reviewed periodically might be a more desirable alternative.

H.R. 6 would also permit tax-exempt financing of enterprise zone facilities engaged in activities other than the manufacturing or production of tangible personal property. This could broaden substantially the types of facilities that could be financed using tax-exempt bonds. The scope of potential employment opportunities in enterprise zones would be broadened accordingly.

Research credit

Under H.R. 6, a 37.5-percent credit would be available to the taxpayer for the lesser of (1) the excess of current qualified expenditures over the base amount (the "general excess") or (2) this same excess if only enterprise-zone research is taken into account (the "enterprise-zone excess").

If the enterprise-zone excess is smaller than the general excess, increases in enterprise-zone expenditures would receive a 37.5-percent credit in addition to any general 20-percent research credit attributable to these expenditures. If the general excess is smaller than the enterprise-zone excess, general increases in expenditures over the general base would receive a 37.5-percent credit in addition to the 20-percent credit available under the general credit.

Under the proposal, base period amounts would not take into account pre-1989 enterprise-zone research in calculating the enterprise-zone excess. If current law were extended, the taxpayer would have a zero base for calculating the enterprise-zone excess in 1989

and a favorable phased-in base for 1990 and 1991. If either the House of Representatives version or Senate Finance Committee version of the research credit became law, the enterprise-zone excess would presumably be calculated under the favorable treatment accorded start-up companies.

For a taxpayer with an enterprise-zone excess smaller than its general excess, the credit provides an incentive to increase enterprise-zone research. On the other hand, much of the increase may result from relocation of research from areas that are not in enterprise zones to enterprise zones. For a taxpayer with a general excess smaller than its enterprise-zone excess, the credit would provide no special incentive for increasing research within an enterprise zone.



ERRATA FOR JCS-16-89

On page 16, GPO dropped footnote 19, which should be as follows:

19/ Under current law, base period research expenses equal the taxpayer's average of qualified expenditures over the three previous years. Under the extension of the credit, as passed by the House in H.R. 3299, base period research expenses would be calculated by multiplying the average ratio of qualified research expenditures to gross receipts over a designated base period by average sales over previous years.